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ECONOMIC OUTLOOK

Chamber of Commerce of the United States November/December 1990

THE ECONOMY AT THE CROSSROADS

The largest tax increase in the history of the United States was signed into law on election day, November 6, 1990. The bill, known as the Omnibus Budget Reconciliation Act, contains a host of destructive tax increases, including higher gas taxes, higher beer and alcohol taxes, a higher airline ticket tax, a 10 percent luxury tax, an increase in payroll taxes, a permanent extension of the telephone excise tax, a higher tax on life insurers, an increased assessment on depository institutions among other fee increases, and a hike in income tax rates, eroding the single positive legacy of the 1986 tax reforms. When all is said and done, the five-year deficit reduction agreement sets out to raise nearly $165 billion in new and higher taxes.

With the economy sliding headlong into recession, this taxing plan is a prescription for both deeper and longer economic pain, higher unemployment and a less competitive economy. On this point, there is a rare consensus among economists of all stripes, whether Keynesian, Classical, or Supply-Side. All reasonable economists believe that raising taxes during periods of economic weakness is counterproductive.

Economic history supports this theoretical belief. Since 1954, real GNP growth in the U.S. economy increased at an average annual rate of 3.0 percent. When tax rates were high in the 1950s and 1970s, output growth dropped well below the 3.0 percent growth trend. When tax rates were lowered in the 1960s and 1980s, real GNP growth jumped above trend.

The federal government's most futile effort to conquer a rising budget deficit with higher taxes occurred in the early 1930s. President Herbert Hoover, faced with a sagging economy and a $2 billion budget deficit in 1931, called for, and later approved a massive tax increase, including drastic hikes in income taxes, excise taxes, and gas taxes. The Great Depression followed.

Our forecast does not suggest that a depression is in the cards, but real GNP growth in the U.S. has been below two percent for the last six consecutive quarters and growth will apparently continue to be below two percent for at least another four quarters. If so, this will mark the longest peacetime period of such slow economic growth since the 1930s.

Clearly, the American economy is at the crossroads. Down one path there is prolonged recession that may linger long enough to qualify as depression. Down the other path, there is a good chance for enhanced prosperity and sustained economic growth. Correcting both the real and imaginary excesses of the 1980s does not require a reversal of strong economic growth.

But slow and falling economic growth was not the major point of concern during protracted deficit reduction negotiations. Instead, politicians and pundits zealously focused on reversing the central policy accomplishment of the 1980s — tax cuts for all Americans — instead pursuing tax increase remedies to the federal budget deficit sickness. Unfortunately, the proposed cure promises to be worse than the disease. The recession will deepen and the deficit will become larger, not smaller.

Instead of raising taxes, a study conducted for the U.S. Chamber and the National Center for Policy Analysis by economists Gary and Aldona Robbins of Fiscal Associates, Inc. recommends a combination of tax cuts and a flexible freeze on the growth of federal spending. Among the policies proposed in this study are reducing the capital gains tax from 28 percent to 15 percent, along with indexing for inflation; instituting neutral

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UNITED STATES ECONOMIC OUTLOOK 1990 - 1991

Prepared by the U.S. Chamber of Commerce
November 1990

(Percent change from previous periods at seasonally adjusted annual rates unless otherwise indicated by shading.)

	QUARTERS								YEARS			
	Actual				Forecast				Actual Annual Average		Forecast	
	90/1	90/2	90/3	90/4	91/1	91/2	91/3	91/4	'83-'88	1989	1990	1991
GROSS NATIONAL PRODUCT												
Nominal GNP	6.7	5.1	5.3	4.1	3.9	4.2	5.2	5.4	7.5	6.7	5.3	4.6
Real GNP	1.7	0.4	1.8	-1.3	-1.7	-0.7	0.9	1.6	4.0	2.5	1.0	-0.3
Consumption	1.1	0.2	3.6	-1.2	-1.9	-0.8	1.2	1.7	4.1	1.9	1.2	-0.1
Residential Investment	15.1	-11.2	-15.4	-8.6	-4.3	0.8	2.3	3.7	10.8	-4.1	-4.0	-4.8
Nonresidential Investment	5.0	-4.7	7.4	-7.1	-6.3	-5.1	1.9	3.1	4.8	3.9	1.2	-2.8
Equipment	5.7	-3.3	8.2	-6.7	-6.7	-5.3	4.2	3.0	8.5	5.2	1.8	-2.4
Structures	2.3	-9.0	5.1	-8.5	-5.0	-4.3	-5.7	3.3	-2.6	0.0	-0.5	-4.1
Exports	11.2	-5.0	1.2	2.6	1.8	1.4	2.5	3.7	6.7	11.0	5.2	1.6
Real Net Exports (82$B)	-35.4	-44.6	-52.5	-50.4	-44.5	-42.8	-41.5	-39.9	-88.7	-54.1	-45.7	-42.2
Imports	2.5	0.7	6.0	1.1	-1.8	0.3	1.6	2.5	10.5	6.0	3.5	0.9
Government Purchases	2.9	6.2	1.3	-0.8	-1.6	-0.3	-0.9	0.8	3.2	2.3	2.5	-0.1
Final Sales	3.8	-0.7	2.0	-0.4	-1.9	-1.0	1.0	1.9	3.8	2.5	1.5	-0.3
Change in Business Inventories (82$B)	-2.2	9.5	7.8	-1.9	0.5	3.5	2.1	-1.5	21.6	23.8	3.3	1.2
Industrial Production	0.6	4.1	3.8	-1.2	-2.2	-1.2	1.1	1.8	4.9	1.7	1.3	0.0
New Car Sales (mill.)	9.8	9.5	9.5	9.1	8.9	8.8	8.7	8.9	10.5	9.9	9.5	8.8
Domestic Car Sales (mill.)	7.0	6.8	6.9	6.5	6.1	6.0	6.0	6.3	7.6	7.1	6.8	6.1
New Housing Starts (mill.)	1.45	1.20	1.14	1.12	1.11	1.16	1.20	1.26	1.68	1.39	1.23	1.18
EMPLOYMENT, WAGES AND PRICES												
Civilian Unemployment Rate (%)	5.2	5.3	5.6	5.9	6.3	6.6	6.9	7.1	7.2	5.3	5.5	6.7
Compensation	3.9	5.0	4.5	4.8	4.1	3.6	5.2	4.5	4.3	3.0	3.5	4.5
Productivity	-1.3	0.3	1.6	-1.3	-0.9	0.6	1.8	1.4	1.9	-0.3	-0.8	0.2
Unit Labor Costs	5.3	4.7	2.8	6.1	5.0	3.0	3.4	3.1	2.3	3.3	4.3	4.3
Consumer Price Index	8.1	3.7	6.4	6.8	6.5	4.6	4.0	3.8	3.5	4.6	5.5	5.6
Implicit GNP Deflator	4.8	4.7	3.4	5.4	5.6	4.8	4.2	3.9	3.3	4.1	4.2	4.9
Prime Interest Rate (%)	10.0	10.0	10.0	10.0	9.8	9.5	9.3	9.0	9.8	10.9	10.0	9.4
3-mos. Treasury Bill Rate (%)	7.6	7.7	7.5	7.3	7.1	7.0	6.8	6.8	7.8	8.1	7.6	6.9
Corporate Bond Rate (%)	9.2	9.4	9.4	9.6	9.6	9.5	9.4	9.2	10.7	9.3	9.4	9.4
Real Personal Disposable Income	2.4	0.3	-0.6	-1.7	-0.8	0.0	0.6	2.3	3.6	2.4	1.0	-0.4
Changes in Profits from Current Production ($B)1	5.9	13.2	4.2*	-6.8	-3.2	0.9	5.6	7.1	29.8	-26.0	7.1	1.5

*Estimated third quarter profits.
1Corporate profits with inventory valuation and capital consumption allowances.

FORECAST ASSUMPTIONS

This month's forecast table contains advance estimates of the National Income and Product Accounts for the third quarter of 1990. The nation's money supply M(2) is assumed to grow by 4.8 percent in 1990 and 5.2 percent in 1991. The trade weighted exchange value of the dollar falls by 9.8 percent in 1990 and by 1.5 percent in 1991.

SOURCE: U.S. Chamber of Commerce, Forecast Section, using the Washington University macro model of the U.S. economy.

cost recovery for equipment; eliminating income taxation of Social Security benefits; and creating "IRA-Plus" accounts.

This pro-growth prescription for an ailing economy would be powerful indeed. Over the next five years, the authors project that these policies would increase GNP in 1995 by almost $500 billion and create over two million jobs. Ironically, these policies would also accomplish something that this year's taxing budget purports to do. This package of tax cuts and spending restraint over the next five years would increase government revenues by $158.4 billion and would reduce the budget deficit by $501.4 billion.

Congress and the Bush Administration rejected a golden opportunity to implement such a pro-growth program of tax cuts and spending restraint this year. They have, in fact, made the economically correct policy path a politically more difficult one to travel in the future. Tax cutting of any kind, long in disfavor among politicians who desire to increase federal spending, was completely rejected and will not become a potent political platform to rally around until the economy sinks a great deal more than it has already. By then, severe economic damage will have worked its way throughout the economy and the economy's growth potential will have waned.

In addition to damaging tax increases, the "reforms" of the budget process also included in the bill erect a more permanent barrier to stifle sensible economic policy making. One such change is the seemingly fiscally responsible "pay-as-you-go" requirement. That is, any future tax, entitlement or other direct spending legislation that either reduces revenues or increases outlays must be off-set with equivalent tax increases and/or spending cuts. Because Treasury Department, Joint Tax Committee and Congressional Budget Office estimators incorrectly score the sort of tax cut proposed in the Robbins study as long-term revenue losers, any such pro-growth policies in the future must be "off-set" with other taxes or spending cuts.

Finding any spending cuts, even when a political consensus develops for pro-growth tax cuts, will be a politically difficult task. It is not that there isn't a great deal of "fat" in the federal budget. There's plenty. Unfortunately, each ounce of budget "fat" has its champion in Congress. Federal spending, cry these defenders of special interests, is already "cut to the bone."

The sad fact is that the only reason for the tax increases in this year's budget package was to preserve new spending and avoid spending cuts. This was effectively masked by political rhetoric indicating that it was high time to raise taxes in order to get more revenues to reduce the budget deficit. Such rhetoric was accepted at face value among pundits and the Washington elite, even though it had no basis in fact.

The data clearly show that tax revenues doubled in the 1980s. One important reason for that was the increase in reported income by higher income earners. The 1981 tax cuts and subsequent reforms kept higher income earners from attempting to shelter their income from tax rates that formerly took 70 cents of every extra dollar earned. This "income" effect was so strong that higher income taxpayers ended up paying the lion's share of income taxes, contrary to the predictions of Keynesian analysts who uniformly predicted falling revenues and economic doom from the initial 1981 tax cuts. The resulting rise in employment and the formation of new businesses further added to the tax base. The end result was a 26 percent increase in real revenues from 1980 to 1990.

In exploring remedies to the rising budget deficit, many legislators overlooked the contribution of federal spending increases as the primary cause of deficits. Indeed, one of the failures of fiscal policy reform in the 1980s was a lack of adequate spending control. Federal spending more than doubled in the 1980s. Spending increased so rapidly that the federal debt outstanding increased by $1.7 trillion in ten years and the annual deficit rose from $70 billion in 1980 to $220 billion in 1990. But this happened during a time when federal revenues went from $517 billion to $1.031 trillion annually. It makes no logical sense to pin rising deficit problems on insufficient taxes and no economic sense to raise taxes as a remedy when the economy is slipping.

If federal spending growth during the 1980s had been held to no more than the rate o. inflation, spending would have reached just $936 billion by 1990. This rate of spending growth would have allowed policy makers to cut the Social Security payroll tax and other economically destructive taxes by almost $100 billion and achieve a balanced budget for the latter 1980s years.

But all through the 1980s, politicians got away with referring to brief periods of restraint in the growth of federal spending as significant spending "cuts." If the current debate over the budget deficit is any indication, entrenched politicians are far less inclined to make anymore "cuts." Since the budget agreement maintains current services baseline accounting, where future spending is assumed to increase by an inflation factor plus large estimates of increased future spending needs, real cuts will not be made. In fact, spending caps in the budget bill can be shifted upward due to "technical" and "economic" corrections. In the past, these "corrections" have always moved spending to higher and higher levels. In effect, the budget bill imposed much less spending restraint than the indirect and often ignored spending strictures under the old Gramm-Rudman-Hollings deficit reduction law.

During the 1980s, federal spending rose an average of $65 billion per year. In every year when spending increases were held to no more than $85 billion and the economy avoided recession, the deficit either fell or stayed approximately the same. In 1989, spending rose $79 billion above 1988 levels, but the deficit was virtually unchanged because the economy grew so

strongly in 1988 and for part of 1989. Deficit targets were still missed in the last part of the 1980s, but not because revenues fell short of expectations. The higher than expected deficits during most years of the 1980s occurred when economic growth averaged four percent per year and revenue growth was strong; thus, the deficits were almost entirely due to excessive spending increases.

Deficit projections were the most problematic in the early 1980s when tax cuts were instituted and the economy was in a recession. However, while the recession cut revenues, the revenue fall from the tax cuts alone in the first few years was not as great as officially predicted. The primary problem in estimating revenues was the drop in inflation that took policy makers by surprise. It wasn't until fiscal year 1984 that revenue estimates fully accounted for the depressing effect of low inflation on federal revenues.

The other problem was attempting to forecast future interest rates. The tax cuts in 1981 were designed to stimulate investment spending and succeeded beyond expectations. However, stimuli to savings were less pronounced. Consequently, real interest rates stayed fairly high in the U.S. This had the effect of attracting foreign investment and foreign savings to the U.S. and put considerable pressure on the dollar to rise.

The central change in the economy since mid-1989 and the added barrier to reducing the budget deficit has been the slowdown in economic growth. In 1990, federal spending rose by $109 billion over 1989 levels, or $44 billion more than the average for the 1980s. At the same time, the economy slipped and federal revenues were almost $50 billion below projections made as late as January 1990. Yet politicians attributed the rising deficit to a lack of taxes. Americans were told that government spending habits had been adjusted as much as they could be to tax cuts that occurred almost 10 years ago. Of course, taxes on corporations and working people had been raised several times after the income tax rate cuts, but spending increases were moderated only during the years 1986 through 1988.

In a failing economy with a rising budget deficit, the political and economic focus should be on curtailing spending increases and stimulating economic growth. The Omnibus Budget Reconciliation Act of 1990 only gives lip service to both these problems. There is no spending restraint other than possible spending cuts for defense. The only hoped for stimulus to economic growth is a decline in interest rates from a fall in the budget deficit.

However, researchers have found that interest rates are much more sensitive to changes in federal spending than they are to the size of the budget deficit. The reason for this is that more federal spending must be funded with either increased revenues or more borrowing. Each method of funding removes savings from the private economy so that less is devoted to non-government activities. Raising taxes removes savings from those who may have begun with very little savings while funding government with more borrowing taps the savings, both foreign and domestic, that are already there.

Increased taxes are a preemptive strike on savings. The discouragement to savings from increased taxes, the specter of at least $110 billion in new spending in 1991, a budget deficit that will likely rise to near $300 billion next year and projections that interest rates will stay up in other major industrialized countries all put upward pressure on U.S. interest rates. Only a dramatic decline in private investment demand in the U.S. due to a prolonged recession will cause U.S. interest rates to fall. But by then, the economic damage will have been done and lower interest rates will only reflect a depressed economy and not as a harbinger of good times to come.

The great economic lesson of the 1980s, which mirrors the lesson of 1960s tax cuts, is that tax cuts add to savings by creating new economic growth, adding to capital formation and growth potential. The private economy did not go on a consumption binge during the 1980s. Investment spending for new capital formation led the surge in economic growth and consumer spending rose no greater than overall real GNP growth. It was Congress that went on a spending spree.

The new budget agreement is a rehash of these same budget games. Dubious deficit reduction is fashioned out of "phantom cuts," cuts delayed and postponed until some time in the distant future. And, of course, the Omnibus Budget Reconciliation Act presupposes future economic growth and revenue increases that are truly optimistic, far above the consensus of Blue Chip Economic Forecasters for the years 1991 to 1995 and much further above what would result from the package of tax increases recently passed by Congress.

If tax increases reduce incentives to produce by just six percent, then the 1990s could be the slowest growth decade since the 1930s. The consensus of Blue Chip Economic Forecasts projects real GNP growth in the 1990s of 2.6 percent. If disincentives reduce real GNP growth to just 2.45 percent from 1991 to 1995, the loss from trend GNP will conservatively accumulate to $100 billion. This would result in a job loss of over 1 million by 1995. Based upon more realistic estimates of interest rates than found in the original budget summit agreement and a below trend growth rate of 2.45 percent for real GNP, the consolidated budget deficit will stand at about $212 billion in 1995 and outstanding federal debt will rise by more than $1.2 trillion in the next five years.

This hardly qualifies as deficit reduction. The precarious status of the economy requires a significant shift in attention toward reviving economic growth. Not only does the budget bill dig the economy into a deeper hole, it may also effectively take away the policy ladder needed to climb back out. But this is not the time to throw in the towel. While the fight for economic prosperity is now harder, it is also that much more urgent that it be won.

A3840-6

ECONOMIC OUTLOOK

Chamber of Commerce of the United States First Quarter 1991

HOW STRONG THE RECOVERY?

Unfortunately for the American economy and the over 1 million newly unemployed, our previous forecast of a recession apparently has come to pass. Last July, we projected a mild, two-quarter-long recession beginning with the fourth quarter of 1990. Advance estimates of fourth quarter GNP show an annualized decline of 2.1 percent, the first quarterly decline since the second quarter of 1986.

There is a general expectation that fourth quarter revisions to real GNP will show a bigger decline than originally reported. The major change is likely to be made to net exports as new figures on fourth quarter export and import activity become available. Estimating net exports is a controversial technical subject. Using a simple and understandable alternative method of deflating exports and imports, the Center for International Business Cycle Research estimates that real GNP fell by 5.2 percent in the fourth quarter. However, regardless of the deflating method chosen, subsequent measures of fourth quarter real GNP should be lower.

Initial data on January 1991 employment show a rise in the unemployment rate to 6.2 percent and a loss of 232,000 nonfarm jobs. In addition, the Purchasing Manager's Index of economic conditions plunged to 37.7, the lowest since May 1982. Clearly, the first quarter of 1991 has gotten off to a poor start. Such discouraging economic news almost guarantees a second consecutive quarter of decline in real GNP and an "official" proclamation that a recession occurred for the first time since 1981-82.

The recession follows about two years of sluggish economic growth. Real GNP increased only by a compound annual rate of 1.5 percent from the beginning of 1989 to the end of 1990. For seven consecutive quarters, beginning with the second quarter of 1989 and continuing through the fourth quarter of 1990, economic growth has been below 2 percent. This comes after six years where real GNP rose at an compound annual rate of 4.0 percent. In addition, inflation has risen to over 5 percent after averaging about 3.5 percent from 1983 through 1988.

The economy has been transformed from a high growth, low inflation path into sluggish growth and persistent inflation in just two short years. These past two years of extremely slow growth has felt like recession to many businesses throughout the U.S. Businesses have responded by curtailing investment and keeping inventories low. Now that the recession is underway, businesses have cut production, trimmed inventories further, laid off workers, and sought the protection of bankruptcy laws. The actual onset of recession merely reflects a spreading of the slowdown to more sectors and areas of the economy, a spread that already was well underway by last July.

If the consensus of private forecasters is correct, by the end of 1992 the economy will have grown by a compound annual average of 1.4 percent dating back to the beginning of 1989. This would be the slowest 4-year growth period for the economy since the 1930s. We believe that growth over this four-year period will be even lower than the consensus forecast.

All protracted periods of slow economic growth with recessions intermixed are serious. The average length of the six postwar recessions was 11 months. The average fall in real GNP from the peak preceding the recession to the end of the recession was 2.6 percent. The consensus of private forecasters is that the current recession will be shorter and shallower than the postwar average largely because the economy has less distance to fall from where it was in mid-1990.

The short, mild recession viewpoint is reflected in the recent forecasts of the Congressional Budget Office (CBO) and the Bush Administration's Office of Management and Budget (OMB). Both forecasts project a two quarter recession followed by very slow growth in the second quarter of 1991. In mid-January testimony, Federal Reserve Board Chairman Alan Greenspan also stated that he believes the recession will end by late spring or summer. Recent Fed actions, however, suggest that the central bank believes the recession to be sharper than it thought in early January.

Indeed, government forecasts and the consensus of private forecasts since last August have tended to underestimate the severity of the recession at every point along the way. Since we made the recession prediction last summer, new information about the seriousness of the economic decline has appeared each month, which leads us

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	QUARTERS							YEARS				
	Actual	Forecast						Actual Annual Average			Forecast	
GROSS NATIONAL PRODUCT	90/4	91/1	91/2	91/3	91/4	92/1	92/2	'83-'88	1989	1990	1991	1992
Nominal GNP	0.3	2.2	3.2	3.8	4.1	4.3	4.6	7.5	6.7	5.0	2.9	4.4
Real GNP	-2.1	-2.2	-1.2	-0.3	0.0	1.7	1.9	4.0	2.5	0.9	-1.0	1.1
Consumption	-3.1	-2.6	-1.6	-0.5	0.2	1.1	1.7	4.1	1.9	1.0	-1.2	0.9
Residential Investment	-15.4	-10.5	-3.6	2.3	3.3	4.0	4.5	10.8	-4.1	-5.1	-9.2	3.2
Nonresidential Investment	-4.6	-6.3	-4.6	-2.3	-2.0	-0.4	1.2	4.8	3.9	1.5	-3.0	-0.5
Equipment	-0.7	-4.5	-3.5	-1.0	-1.5	0.7	1.9	8.5	5.2	2.4	-1.2	0.2
Structures	-16.5	-12.2	-8.5	-6.7	-3.6	-4.4	-1.2	-2.6	0.0	-1.1	-8.8	-3.3
Exports	7.8	0.1	3.5	2.5	3.7	3.8	3.5	6.7	11.0	6.2	3.2	3.4
Real Net Exports (82$B)	-23.6	-22.1	-13.8	-12.4	-10.5	-7.3	-5.0	-88.7	-54.1	-37.5	-14.7	-5.0
Imports	-6.3	-0.8	-1.6	1.6	2.5	1.8	2.1	10.5	6.0	3.2	-0.4	1.9
Government Purchases	4.9	0.3	-0.3	-0.9	-1.1	-0.9	-1.3	3.2	2.3	2.8	1.3	-1.3
Final Sales	-0.1	-2.7	-1.0	-0.6	0.0	1.0	1.4	3.8	2.5	1.5	-0.8	0.6
Change in Business Inventories (82$B)	-16.3	-11.4	-13.5	-10.9	-10.7	-8.1	-5.8	21.6	23.8	-1.1	-11.6	-0.8
Industrial Production	-7.9	-5.1	-2.9	-0.4	1.3	2.1	2.7	4.9	1.7	0.9	-2.6	1.4
New Car Sales (mill.)	9.0	8.2	8.0	8.4	8.9	9.1	9.2	10.5	9.9	9.5	8.4	9.3
Domestic Car Sales (mill.)	6.6	5.9	5.8	6.1	6.3	6.5	6.6	7.6	7.1	6.9	6.0	6.7
New Housing Starts (mill.)	1.05	1.00	1.03	1.05	1.12	1.15	1.20	1.68	1.39	1.21	1.05	1.21
EMPLOYMENT, WAGES AND PRICES												
Civilian Unemployment Rate (%)	5.9	6.3	6.8	7.2	7.5	7.6	7.7	7.2	5.3	5.5	6.9	7.6
Compensation	3.8	5.1	5.0	3.9	4.2	5.8	4.7	4.3	3.0	3.5	4.6	4.8
Productivity	0.1	-0.9	0.6	0.6	0.4	0.7	0.9	1.9	-0.3	-0.8	0.1	0.8
Unit Labor Costs	3.7	6.0	4.4	3.3	3.8	5.1	3.8	2.3	3.3	4.3	4.5	4.0
Consumer Price Index	6.9	5.0	4.6	4.0	3.4	4.5	4.3	3.5	4.6	5.4	5.2	4.2
Implicit GNP Deflator	2.8	4.2	4.4	4.1	4.0	3.1	3.0	3.3	4.1	4.0	4.0	3.4
Prime Interest Rate (%)	10.0	9.2	8.8	8.5	8.5	8.5	8.5	9.8	10.9	10.0	8.8	8.5
3-mos. Treasury Bill Rate (%)	7.0	6.1	5.9	5.8	5.7	5.8	5.9	7.8	8.1	7.5	5.9	5.9
Corporate Bond Rate (%)	9.3	8.9	8.7	8.7	8.8	8.7	8.6	10.7	9.3	9.3	8.8	8.6
Real Personal Disposable Income	-3.6	-1.3	-0.2	0.7	2.3	1.5	1.2	3.6	2.4	0.8	-0.9	1.6
Changes in Profits from Current Production ($B)1	-6.8*	-3.2	0.9	5.6	7.1	4.1	1.6	29.8	-26.0	-12.1	-3.6	15.9

*Estimated fourth quarter profits.
1Corporate profits with inventory valuation and capital consumption allowances.

FORECAST ASSUMPTIONS

This forecast table contains advanced estimates of the National Income and Product Accounts for the fourth quarter of 1990. The nation's money supply M(2) is assumed to grow by 4.4 percent in 1991 and by 4.8 percent in 1992. The trade weighted exchange value of the dollar falls by 1.5 percent in 1991 and rises by 3.0 percent in 1992.

SOURCE: U.S. Chamber of Commerce, Forecast Section, using the Washington University macro model of the U.S. economy.

to believe that the recession will be deeper and longer than we originally anticipated. While our original recession forecast is now reflected in the consensus forecast, and OMB and CBO forecasts, these forecasts may be overly optimistic. We believe that the recession will last at least until the fall of 1991, which places us on the more pessimistic side of the forecasting pack.

The economic events leading up to this recession are different from what has occurred in the past. The recession did not come upon us all of a sudden. It was a result of cumulative anti-growth policies that first slowed the economy down from strong economic growth and then removed significant amounts of growth potential. In the process, asset values, particularly real estate values, declined and accumulated debt became a severe burden on corporate cash flows.

In order to achieve its goal of reducing economic growth in a robust economy, the Fed had to take extraordinary action. In doing so, it discouraged capital formation and destroyed growth potential so that now the Fed will have to take extraordinary action to induce added growth. But loose monetary policy cannot increase growth potential without igniting inflation and creating a situation where the Fed must revert to a policy that started the economy down in the first place. Fed-induced recession does not lead to Fed-inspired recoveries that can last.

What concerns us is not only how long and deep the recession may turn out to be, but how strong will be the eventual recovery. The prevailing consensus forecast for the recovery is exceptionally low. Typically, for a full year following postwar recessions, real GNP rose on average by 6.1 percent. The current consensus of private forecasters is for a recovery of just 2 3 percent real growth. Several forecasts, including those of the CBO and OMB, project the recovery growth rate between 3 and 4 percent, somewhat higher than the consensus, but still quite a bit below the average postwar experience.

Analysts point to a couple of reasons why the recovery might be poor. First, "excessive" debt accumulations will not be worked off during the recession and, therefore, businesses and consumers will be reluctant to go on spending sprees any time soon. Of course, private debt only became "excessive" when the economy grew more slowly.

Second, the costs of the war, enormous federal payments to cover deposit insurance losses, rapidly growing federal domestic spending and the unexpected recession will cause the budget deficit to hit all-time highs in 1991 and 1992. Consequently, analysts argue that interest rates will fail to fall far enough to promote a strong recovery. Indeed, even if the Fed cuts the federal funds rate to below 6 percent, banks will not likely increase private lending to a significant degree in order to bolster what is feared to be insufficient capital and to satisfy new banking regulations — a continuation of regulatory policies that contributed greatly to an economy-wide credit crunch. As a consequence, while interest rates on government securities may continue to fall for several months as investors seek safe places for funds, private interest rates may stay relatively high.

While debt, the war, the budget deficit and banking regulation are important factors in charting the future course of the economy, there are other more fundamental factors retarding economic growth that have, in some instances, persisted for several years. We refer to numerous policy actions by government that have stopped healthy economic growth and are responsible for the recession and the poor climate for future economic growth. These policies, if uncorrected, will lead to an anemic recovery and, perhaps, a decade of very slow economic growth with intermittent lapses back into recession.

Our pessimistic outlook has its origins in anti-growth policies found in the Tax Reform Act of 1986. That legislation raised the capital gains tax, made it difficult to deduct legitimate business expenses and altered greatly the tax treatment of real estate holdings. As a result, asset values have slipped, especially real estate values.

Falling real estate values not only increased the insolvency of many thrifts and reduced the solvency of most banks, but it put a damper on the rise in household and business asset values. This situation has a known cure. Relief in the form of a lower capital gains tax rate would increase asset values, improve the solvency of financial services institutions and stimulate economic growth. A capital gains tax cut is one of the most powerful pro-growth policies that could be enacted at this time and would increase growth potential in the years ahead.

But other anti-growth policies must also be contained or reversed. The rise in the capital gains tax and the increased taxation of business alone did not put the economy into such a slow growth period and precipitate a free-fall into recession. Instead, severe and unceasing Fed high interest rate policy designed to slow the economy down was the major culprit for sluggish growth and the recession.

Fed high interest rate policy dates back to the spring of 1988 as a much ballyhooed step to quell what the Fed believed was a whole series of indications that the economy was suffering from rising inflationary pressures. The Fed redoubled its anti-growth efforts in early 1989 and has continued its slowdown policy to date in spite of the fact that interest rates have fallen over the past six months.

In fact, since August 1987 when Alan Greenspan took over the Fed, *bank reserves have not increased*. While the Fed led the way for the run-up in interest rates by over 300 basis points in 1988 and 1989, the subsequent decline in interest rates by nearly that amount has not been led by the Fed, but rather occurred as a result of the economic slowdown. Growth in bank reserves and money supply have declined since last June indicating that monetary policy was becoming "tighter" as the economy dipped into a recession. The Fed has merely been reluctantly following credit market interest rates on government securities downward since the middle of 1990 and may have intended to moderate interest rate declines.

Moreover, these interest rate movements suggest that a bad joke has been played on the American public. All last year when holding the line on taxes was being compromised away, Americans were told that deficit reduction regardless of how it is achieved would lead to lower interest rates. Last November when taxes were raised to reduce the deficit, the deficit actually ballooned upward as massive spending increases were well underway. Yet interest rates have fallen anyway because the Fed has allowed them to. All along it was the Fed that kept rates high, not the budget deficit per

se. The resulting agreement to raise federal taxes and increase federal spending, the creation of a recession and the enormous rise in the budget deficit have been the domestic equivalent of being hit with "friendly fire."

The credit situation is so strained that even if the Fed begins to lead rates down with increased reserves, there is little reason to believe that Fed policy can bring the economy back. Fed policy alone cannot alleviate a credit crunch nor induce businesses to invest again. Now that the monetary authorities more fully realize the extent of the present slowdown, a shift in Fed action away from anti-growth policy is still likely to be thwarted by fiscal and regulatory policies that are also hitting the economy hard.

The regulatory budget of the government will rise in fiscal years 1991 and 1992. Although there are no precise measures on a program-by-program basis, it has been estimated by former Council of Economic Advisors chairman Murray Weidenbaum that an overall increase of $1 in regulatory spending will increase business compliance costs by $20. Consequently, the economy may incur additional compliance cost expenditures of over $200 billion in 1991 and again in 1992. When the Clean Air Act is eventually implemented, that legislation alone may add as much as $40 billion a year to compliance costs. Such costs reduce output, lower productivity and raise prices — exactly what has occurred in 1989 and 1990 and precisely the opposite of what is needed to reverse a period of sluggish growth.

Contrary to popular misunderstanding, fiscal policy is also acting as a drag on the economy. It is well known that tax increases stifle economic growth. In 1991 alone, taxes have been raised by over $20 billion as part of the largest tax increase in U.S. history -a bill that was signed into law last November when the economy was already in the recession. By way of comparison, the amount of this tax is equivalent to $30 per barrel oil, a large enough oil price to reduce any forecast of economic growth. Additional tax increases next year will come on top of 1991 increases that will act to stifle incentives to produce and invest and will lead to further retardation of economic growth.

It is less well understood that government spending instead of being a stimulus to the economy serves as an inhibitor of economic growth when it gets above a certain amount. Most governments tend to spend beyond a prudent amount and, often, well beyond their present means. Comparing the experience of various industrialized nations, a study by Gerald Scully shows that a 10 percent rise in government spending as a percentage of GNP would reduce economic growth by 1 percent. That is, if federal spending were to increase to 25 percent of GNP as projected for 1991 and 1992 from where it stood in 1989 at about 22.5 percent, real GNP growth would permanently decline by about 1 percentage point. In an economy the size of the U.S., this amounts to about $40 billion per year in lost output. This may appear to be a modest amount as compared to the size of the federal budget alone, but this dampening effect on GNP increases and compounds itself each year as long as federal spending stays up as a percent of GNP.

The magnitude of excessive federal spending can be illustrated by the lag between expenditures and revenues. It won't be until 1995 that the federal government receives sufficient revenues to afford to spend at the levels now proposed for 1992. Thus, the federal government is three full years ahead of its income on the spending side. If the ordinary American were faced with such a "deficit," he would be compelled to cut expenditures. Even if he sought a loan, lenders would require that he bring expenditures into line with income in short order.

What we are left with is an economy with diminished growth potential. Higher tax rates, an increased percentage of GNP devoted to government spending, increased regulation especially in banking, capital gains taxes that are too high and a credit crunch on business that stifles what productive investments remain all contribute to a decline in capital accumulation. At the same time, a socialized system of deposit insurance is draining capital from the economy to keep insolvent and poorly run banks and thrifts in business.

This period of extremely slow growth in the U.S. economy is an anomaly. Generally speaking, market economies produce strong economic growth. As prerequisites for growth, market economies rely primarily on well-defined private property rights and established rules of doing business in free markets. But one key to success is to allow failing businesses to go under so that they do not continue to drain capital from successful businesses throughout the remainder of the economy. Schemes such as deposit insurance keep failing firms in business by encouraging poorly run banks and thrifts to make unsound loans thereby destroying incentives to reduce those activities that are unprofitable and wasteful of society's scarce capital resources.

Our real concern is with the future of economic growth. Market economies naturally grow which is why so much of the communist world is seeking to get in on a good thing. We don't doubt that the U.S. economy could experience 5 percent real GNP growth over many years if policy impediments to growth are removed. But these impediments are so pervasive today that the economy will be fortunate to rise by 2 percent for any extended period in the next few years.

Unfortunately, we have also concluded that the policies that have led to such low growth potential will not be changed any time soon. Policy makers would rather blame poor economic performance on certain foreign nations or higher oil prices or even on sunspots than examine and alter their own failed policies.

In Washington today there is a severe lack of leadership on economic matters. Evidently, policy makers are willing to let the recession run its course, hoping that it will be short and the recovery large enough during an election year to maintain voter support. If that is the strategy, government officials will be watching export growth carefully. Export orders continue to be the bright spot in the overall economic picture. However, leading indicators for 7 of our 9 largest trading partners have turned downward. Canada and Great Britain are already in a recession. The future for exports rides on how well our trading partners do. It is a risky gamble to let interest rates do all the work at home while relying on strong growth elsewhere to keep the U.S. economy growing.

The administration's budget for 1992 is being praised by some observers for its honesty. OMB projects economic growth at or above 3 percent for 1992 through 1996. Unfortunately, this is a far cry from what current government policies are likely to produce.

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ECONOMIC OUTLOOK

Chamber of Commerce of the United States — Second Quarter 1991

ECONOMIC STAGNATION AHEAD

What do you get from increased regulation, government spending and taxes? No economic growth. From the beginning of the second quarter of this year to the end of the first quarter in 1992, real GNP growth will be stagnant—two quarters of slightly positive economic growth will be sandwiched around two quarters of declining real GNP.

This relatively dismal Chamber forecast is not in keeping with our typical upbeat appraisal of the economy that dominated our thinking from 1983 through 1988. The major reason for our turnabout has been an accelerating change in federal government policy from one that was pro-growth to one that is decidedly anti-growth. This policy reversal actually began to occur with the 1986 Tax Reform Act which, when reforms became fully implemented, dramatically increased the cost of capital.

Even during 1989, our forecast for economic growth, although below previous years forecasts, was then above the consensus forecast because we believed that policy makers would shift toward more pro-growth policies. That did not happen. Although we continue to push for pro-growth federal policies, for purposes of our forecast we no longer anticipate a reversal of anti-growth policies in 1991.

During the six recessions from the late 1950s to the present, there was at least one quarter of positive real GNP growth amidst three or more quarters of declines in real GNP. We expect this recession to be similar—two quarters of real GNP decline before and after a very slight upturn in the second quarter of 1991. The total of four negative quarters puts the length of the current recession on a par with ones in 1969-70, 1974-75 and 1981-82. Although the drop in real GNP from its peak in the third quarter of 1990 will not be as severe as the loss in real GNP in the previous two recessions, our major concern is that the eventual recovery will be weak, leaving the economy vulnerable to a new recession.

More optimistic forecasters can point to a few statistics that yield a small ray of hope that the recovery will start "on schedule" in the second half of 1991. Leading indicators rose by 1.1 percent in February. Housing starts, although they fell by 9 percent in March, are still higher than the dreadful January number. Real consumption in February rose from a low point in January. Money supply growth has picked up in the first three months of 1991, and so far exports in 1991 continue to rise.

Fueling this optimistic view is the notion embedded in standard forecasting models that what goes down must eventually come up. Unfortunately, these models have not been adjusted for the rapidly rising costs to business of new regulations, regulatory-induced credit restraint that is stifling the growth of small-sized and medium-sized businesses, increased taxes equivalent to $30 per barrel oil prices, the rising share of federal government expenditures in the economy that removes resources and capital from private markets, and the lingering effects of Fed high interest rate policy that keeps interest rates from falling sufficiently to spark an early recovery.

The anti-growth stance of federal government policy which created sub-par growth and the recession in the first place will lead to a much longer period of extremely slow growth than is generally anticipated and will result in an anemic recovery in 1992. The earliest a recovery could begin is in September based upon the possibility of a favorable upturn in the Long Leading Index computed by the Center for International Business Cycle Research for March and April. Yet even if the recovery starts in the fourth quarter of 1991, it will be small by historical standards and may not stop the unemployment rate from increasing.

Although monthly government reports on the economy are erratic and difficult to interpret, it appears to us that negative reports still dominate the economic picture to date. Employment has fallen by an annual rate of 2.8 percent in the first three months of 1991. This will lead to slowly rising personal income. In fact, disposable income when adjusted for inflation will likely fall throughout 1991, leading to a decline in real consumption expenditures. Retail sales, a statistic not adjusted for inflation, will only rise about 2 percent in 1991.

On the production side, factory orders and orders for capital equipment have dropped sharply in the first two

Economic Outlook, published quarterly the Forecasting Section, Chamber of Commerce of the United States of America, provides its readership with the Chamber's official forecast of the U.S. economy. It analyzes the vital issues affecting current economic activity and provides the latest economic trends. Subscription cost is $60.00 per year which includes *Policy Working Papers*.

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UNITED STATES ECONOMIC OUTLOOK 1990 - 1991

Prepared by the U.S. Chamber of Commerce
Second Quarter 1991

(Percent change from previous periods at seasonally adjusted annual rates unless otherwise indicated by shading.)

	QUARTERS							YEARS				
	Actual	Forecast						Actual Annual Average			Forecast	
	90/4	91/1	91/2	91/3	91/4	92/1	92/2	'83-'88	1989	1990	1991	1992
GROSS NATIONAL PRODUCT												
Nominal GNP	0.9	2.0	3.2	3.4	4.1	4.3	4.6	7.5	6.7	5.1	3.0	4.3
Real GNP	-1.6	-2.4	0.4	-1.1	-0.5	1.4	1.9	4.0	2.5	1.0	-0.8	0.9
Consumption	-3.4	-3.1	0.6	-0.9	-0.8	1.1	1.7	4.1	1.9	0.9	-1.1	0.8
Residential Investment	-20.6	-11.9	-3.6	2.3	3.3	4.0	4.5	10.8	-4.1	-5.4	-10.6	3.2
Nonresidential Investment	0.1	-6.3	-4.6	-3.8	-2.0	-0.4	1.2	4.8	3.9	1.8	-2.3	-0.7
Equipment	6.3	-3.1	-3.4	-2.5	-1.5	0.7	1.8	8.5	5.2	2.8	0.3	0.0
Structures	-18.2	-17.5	-8.9	-8.5	-3.8	-4.5	-1.2	-2.6	0.0	-1.2	-10.6	-3.6
Exports	11.0	1.0	-1.3	-1.9	0.7	3.8	3.5	6.7	11.0	6.4	2.3	2.0
Real Net Exports (82$B)	-8.8	-4.9	-6.2	-10.1	-7.0	-3.8	-1.5	-88.7	-54.1	-33.8	-7.0	-1.3
Imports	-11.8	-1.4	-0.5	0.5	-1.2	1.8	2.1	10.5	6.0	2.8	-1.8	1.1
Government Purchases	4.7	1.7	1.2	-1.8	-3.2	-0.9	-1.3	3.2	2.[illegible]	2.8	1.6	-1.7
Final Sales	1.4	-2.5	-0.2	-1.7	-1.0	0.9	1.4	3.8	2.5	1.6	-0.5	0.3
Change in Business Inventories (82$B)	-26.4	-25.1	-18.9	-12.7	-7.8	-3.1	2.4	21.6	23.8	-3.6	-16.1	6.7
Industrial Production	-7.0	-9.3	-2.9	-1.1	-0.1	2.1	2.7	4.9	1.7	0.9	-3.6	1.1
New Car Sales (mill.)	9.0	8.0	8.0	8.4	8.9	9.1	9.2	10.5	9.9	9.5	8.4	9.3
Domestic Car Sales (mill.)	6.6	5.9	5.8	6.1	6.3	6.5	6.6	7.6	7.1	6.9	6.0	6.7
New Housing Starts (mill.)	1.04	0.92	1.03	1.05	1.12	1.15	1.20	1.68	1.39	1.21	1.02	1.21
EMPLOYMENT, WAGES AND PRICES												
Civilian Unemployment Rate (%)	5.9	6.5	7.0	7.5	7.8	8.1	8.2	7.2	5.3	5.5	7.2	8.0
Compensation	3.8	5.1	5.4	3.9	4.2	5.8	4.7	4.3	3.0	3.5	4.7	4.8
Productivity	0.1	-0.9	0.6	0.6	0.4	0.7	0.9	1.9	-0.3	-0.8	0.1	0.8
Unit Labor Costs	3.7	6.0	4.8	3.3	3.8	5.1	3.8	2.3	3.3	4.3	4.6	4.0
Consumer Price Index	6.9	2.4	3.7	4.4	5.0	4.5	4.3	3.5	4.6	5.4	4.5	4.5
Implicit GNP Deflator	2.8	3.9	2.6	4.3	4.4	3.1	3.0	3.3	4.1	4.1	3.6	3.4
Prime Interest Rate (%)	10.0	9.2	8.8	8.5	8.5	8.5	8.8	9.8	10.9	10.1	8.8	8.9
3-mos. Treasury Bill Rate (%)	6.1	6.0	5.7	5.6	5.7	5.8	5.9	7.8	8.1	7.5	5.7	6.0
Corporate Bond Rate (%)	8.9	8.9	8.8	8.8	9.0	9.0	8.9	10.7	9.3	9.3	8.9	8.9
Real Personal Disposable Income	-3.5	-1.5	0.3	-0.6	-0.4	1.5	1.2	3.6	2.4	0.9	-1.1	1.0
Changes in Profits from Current Production ($B)1	-6.8	-4.6	-1.0	-1.8	4.3	4.1	1.6	29.8	-26.0	-11.7	-9.5	9.0

[1]Corporate profits with inventory valuation and capital consumption allowances.

FORECAST ASSUMPTIONS

This forecast table contains final estimates of the National Income and Product Accounts for the fourth quarter of 1990. The nation's money supply M(2) is assumed to grow by 4.6 percent in 1991 and by 4.5 percent in 1992. The trade weighted exchange value of the dollar falls by 0.3 percent in 1991 and rises by 4.3 percent in 1992.

SOURCE: U.S. Chamber of Commerce, Forecast Section, using the Washington University macro model of the U.S. economy.

months of 1991, while industrial production in the first quarter fell at an annual rate of 9.3 percent. The National Association of Purchasing Managers index of the economy, which stands below 44, is still signalling a general business contraction. It is unlikely that this index will move above 50, a sign that recovery is underway, before the end of the year. Coincident indicators of economic activity have dropped sharply in the first two months of 1991 and will have to be growing above 4 percent before a recovery can be confirmed.

There have been mixed reports on inflation for the first three months of 1991. The overall Consumer Price Index (CPI) grew only 2.4 percent through March while the overall Producer Price Index for Finished Goods (PPI) fell at an annual rate of 3.9 percent. However, when volatile food and energy prices are removed from each index, generating the so-called core CPI and core PPI, inflation has picked up from what it was in all of 1990. The core CPI rose at an annual rate of 6.8 percent in the first three months of 1991 while the core PPI rose by 4.4 percent.

The outlook for inflation depends upon economic growth in the economy. If production of goods and services picks up, price rises will be subdued. However, if the economy is stagnant over the next twelve months as we predict, inflation may actually rise from current rates. Money supply growth in the last few months has increased enough to result in growing aggregate demand (nominal GNP) as 1991 proceeds. Yet if real GNP fails to grow, all of the increase in aggregate demand will go to rising prices. Inflation by most measures should be lower in 1991 than in 1990, but the overall CPI and PPI will rise in the third and fourth quarters of this year as real GNP fails to rise. Already gasoline and oil prices have begun to increase modestly after sharp declines in the first three months of 1991.

Real GNP should fall for the second consecutive quarter in the first quarter of 1991. The decline could be stronger than our forecast of 2.4 percent although the consensus of private forecasters places the first quarter decline at 1.8 percent. A sizeable drop in real consumption will contribute to the fall in first quarter real GNP. This will mark the third consecutive quarterly decline in real consumption, an event that last occurred 44 years ago.

These declines in consumption were the direct result of deliberate anti-growth policies undertaken by the Fed beginning in 1988. High interest rate Fed policy combined with rising taxes and increased regulation has led to a long period of below trend growth. Starting with the second quarter of 1989, real GNP growth has been below 2 percent for what will be 8 consecutive quarters when the GNP report comes out April 26. This exceeds the 7 consecutive quarters of below 2 percent growth recorded during 1981 and 1982.

The point is that regardless of when a recession emerged and regardless of its length and severity, the economy has been growing below trend for a considerable period of time. The peak of the latest growth cycle occurred in February 1989 and now two years later, the trough still has not been established. The last lengthy period of below trend growth occurred between December 1978 and December 1982 when federal government policy was also strongly anti-growth.

If the consensus of private forecasters is correct about real GNP growth in 1991 and 1992, keeping in mind that the consensus forecast is more optimistic than ours, the economy will have grown by a compound annual rate of just 1.5 percent from the beginning of 1989 through the end of 1992. This would mark the lowest 4 year rate of growth in real GNP since the 1930s and it would at least equal in duration the 4-year-below-trend growth cycle experienced during the last part of the 1970s and the early years of the 1980s.

Although we would like to see the sort of near-term recovery assumed in the Bush administration forecasts (CEA and OMB), in the Congressional Budget Office (CBO) forecast and an apparently similar forecast at the Fed, we believe that federal policies do not justify such a heightened degree of optimism. That is why we are dumbfounded that the administration, Congress and the Fed all seem hell-bent on maintaining a policy status quo. They persist in their belief, really a wish, that the long economic slowdown shortly will become history and that the recession will naturally lead into a period of above trend growth. This over-the-rainbow approach to policy making does not address the seriousness of the slowdown to date, nor does it recognize the significant likelihood that the economy will continue to slide for a considerable period of time. We can expect little policy relief as the economy suffers from slow growth and lost growth potential.

The costs of a delay in shifting to pro-growth policy appear to be enormous. Over the next year, a stagnant economy will result in a high and rising unemployment rate. Another 2 million jobs will be lost and almost 60,000 businesses will fail. The unemployment rate will likely rise to over 8 percent by the first quarter of 1992 and capacity utilization of the nation's factories will slip to below 75 percent. Low and falling unemployment and high and rising capacity utilization have been used by the Fed in the past as reasons to raise interest rates to slow the economy down. Surely, the reverse should be the case. However, the Fed, even in the face of a recession and declining market interest rates, has been reluctant to let the fed funds rate fall, a reluctance that continues to dominate Fed policy making.

But the Fed cannot undo its own past policy mistakes and create an adequate recovery without help from other federal policy makers. Indeed, an overzealous attempt to do so would only fuel more inflation. There is a tendency for the Fed to follow a given interest rate policy for too long resulting in recession and excessive inflation. It is not that the Fed is obstinate, it's just that analysts at the Fed do not know for sure where the economy is at the present time and where it is headed with any greater precision than the rest of the nation's forecasters. Hence, the Fed has been correctly criticized for making policy mistakes when it misreads the economy.

Moreover, the Fed tends to adhere to bogus theories of the economy. They believe that more employment will cause inflation to rise despite empirical evidence to the contrary. Consequently, most of the time the Fed only has enough data and knowledge of the economy to do considerable harm. We have long argued that the Fed should set a money supply growth target which is adjusted

for defined changes in a sensitive price basket. The Fed should try to hit that target for all to see to minimize its inherent negative effects on the economy. As a result, market participants, who are better able to judge what will likely happen to the economy, will be able to hedge against Fed policy changes and will be faced with fewer policy-induced, economy-wide disruptions.

The sort of help the Fed and the economy need is clear. Tax cuts are necessary to decrease the disincentives to work and invest. The growth in federal regulation must be sharply curtailed to keep small and medium sized businesses from experiencing the nightmare of costly compliance with new and unclear regulations. Federal spending growth should be brought to a halt to reduce the drain of resources and capital from the private sector. The federal government will spend a peacetime record of 25 percent of GNP this year and next, far beyond the 40-year trend rate of near 19 percent.

One reason real GNP has held up as well as it has with falling real consumption has been rising exports. Unfortunately, leading indicators of economic activity among our major trading partners are flagging. Canada, the United Kingdom and Australia are already in a recession. Leading indicators in Japan have fallen sharply. European demand for U.S. produced goods may fail to grow in 1991. Consequently, policy makers cannot count on more export growth to bolster real GNP and prompt a swift and sizeable recovery.

Another source of optimism cited by several analysts is the decline in interest rates over the past several months and the expectation by some analysts that interest rates will decline further. This, they argue, will result in a lower cost of capital and spur renewed economic growth. The major reason for declining interest rates has been a decline in the demand for funds due to a lack of profitable new ventures. This is hardly a reason for increased confidence in future economic activity. Last June, even before the Fed reluctantly lowered its target for the federal funds rate, interest rates began to drop as the economy entered recession and investment opportunities dried up. Something else besides lower interest rates is needed to get economic growth going again.

Falling interest rates are most likely a consequence of the rising cost of capital. For many small businesses and some medium sized businesses, the cost of capital has risen substantially as a result of a credit crunch originally inspired by niggardly growth in bank reserves and compounded by overzealous banking regulators. The closure of some banks and thrifts resulted in a loss of credit for businesses who had never missed a payment on their loans, but whose loans ended up in collection banks. Those collection banks called in loans. Collection banks are not set up to extend loans. Once a business through no fault of its own has its debts passed on to collection banks, no other banks will extend new credit.

Even if this catastrophe had not occurred, banking regulators forced even well-run banks into requiring more collateral on performing loans, lest the bank suffer from a poor regulatory report card. Banks, totally uncertain about where regulators would strike next, have cut back on loans and raised their standards to such an extent that Fed surveys indicate extreme tightness in lending. Such uneven and unpredictable regulatory scrutiny, far in excess of what is necessary, has put a chill on loans and, in effect, has raised the cost of capital to growth-oriented businesses.

To stop the slide in the economy sooner rather than later and to provide for a more vigorous economic recovery that is far less prone to fail, the cost of capital and the cost of labor should be cut. The quickest way to do this is to cut taxes.

The cost of labor depends upon prevailing wage rates, payroll tax rates and benefit packages. Wage rates and benefit packages are competitively determined given the performance of the overall economy and specific tax laws that affect compensation in the form of wages and benefits. One clear way to reduce payroll costs is to cut the Social Security payroll tax. Not only would this be a direct saving to business and thus spur more employment growth, but it would also leave wage earners with larger after-tax incomes to prop up flagging personal income growth.

The make-up of the cost of capital is slightly more complicated. It includes a sufficient pretax profit to a business to cover taxes required by law (including Social Security payroll taxes), to cover interest required by lenders, and to provide a sufficient payment of dividends and capital gains required by equity holders. Note that a decline in interest rates lowers the cost of capital. But the expectation of further interest rate declines will raise the cost of capital because it increases the amount of capital gains prospective equity holders can obtain from holding bonds. This is why Fed policy that slows the decline in interest rates retards future economic growth.

If corporate taxes could be cut by more sensible depreciation rules and if a capital gains tax cut were to be enacted, the cost of capital could be unambiguously reduced. These tax cuts would lower the amount of pretax profit necessary to cover taxes and would spur more production and increased employment. In addition, the cost of capital could be lowered by spurring additional savings with new IRA laws.

If pro-growth fiscal policy steps fail to materialize this year and if the pace of introduction of new regulations fails to slow, the growth potential of the economy will stay down near 2 percent. This is the major reason that the eventual recovery will be so weak.

In recent history, after one year following the end of a recession real GNP has risen on average by 5 percent or more before settling back down to growth rates closer to growth potential. The strongest and longest-lasting recoveries have occurred when policy makers, mired in recession, have shifted to pro-growth policies and thereby raised growth potential above what it was going into the recessionary period. Although not yet reflected in many models of the U.S. economy, growth potential has been cut in half since the beginning of 1989.

A lower rate of growth potential will result in high rates of unemployment and be accompanied by poor growth in productivity. This is a sure recipe for continued slow growth in personal income over the next several years and should be a major concern among U.S. policy makers. Regretfully, there is no end in sight to the anti-growth policies of the federal government.

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ECONOMIC OUTLOOK

Chamber of Commerce of the United States

Third Quarter 1991

WHEN WILL THEY EVER LEARN?

Fiscal, monetary and regulatory policy have produced several turning points for the economy in the last ten years. A clear understanding of these policies and their likely impact on the economy has been a fundamental part of our forecasts. In 1981, anti-growth high interest rate Fed policy created a long and severe recession. It was not too difficult to predict that recession. Pro-growth tax cuts were passed in 1981 and put into effect in 1982 and 1983. These tax cuts led to a long economic expansion. Our forecasts were generally optimistic after the tax cuts and, hence, accurate.

Federal policy from 1983 to 1988 was not all pro-growth, but on balance, anti-growth policies were mostly offset by positive policy changes. Social Security payroll taxes were raised, as were capital gains taxes and corporate taxes. But these increases were off set by cuts in high marginal income tax rates. Growth in regulatory activity was subdued by 1970s standards, and the Fed did not attempt fundamental manipulations of the economy. The major anti-growth activity in the 1980s was the increase in federal spending as a portion of the economy. However, beginning in 1986 when the Gramm-Rudman limits were imposed, spending growth dropped.

That precarious balance was upset by policy changes in 1988, 1989 and 1990, eventually turning all aspects of federal policy decidedly anti-growth. In mid-1988, the Fed set out on a misguided policy of high interest rates in an attempt to cut inflation by slowing real GNP growth. Subsequently, economic growth began its long slide downward while inflation rose slightly. Our forecast remained fairly bullish up through mid-1989 because we believed the Fed would not maintain its destructive stance. Yet without evidence of a decline in inflation, the Fed remained intent on slowing the economy further and to this day follows a policy of keeping interest rates from falling.

By mid-1989, the economy was swamped by a rising tide of re-regulation. During political debate over major thrift industry bailout legislation, few legislators seemed willing to admit that government regulatory policies had created the crisis in the first place. Instead of recognizing regulation as the problem, official Washington pursued stepped-up controls with new vigor.

By mid-1990, talk of new tax increases became politically acceptable — even as the economy's expansion was grinding to a halt. Federal spending as a portion of the economy was clearly on the rise. The symbolic goal of the Reagan era — to limit the size of government — no longer existed as a constraint on public policy. By the end of July 1990, the government revised earlier real GNP estimates downward, coinciding with major budget summit tax proposals. At that point, it was obvious that the economy was falling headlong into recession.

The economy proceeded to decline in the fourth quarter of 1990 and the first quarter of 1991. Revised GNP figures showed that the economy declined again in the second quarter of this year. Although the revision was slight and the decline in real GNP was minimal, the third consecutive quarterly decline in real GNP prompted columnist Hobart Rowen of the *Washington Post* to declare: "The skeptics about the economy were right, and the optimists — including high Bush administration and some Federal Reserve Board officials — were wrong.... This is a case where the nation's leading business organizations, including the U.S. Chamber of Commerce... called the shots almost precisely — but were hooted down as naysayers by many leading academics."

Economic Outlook, published quarterly by the Forecasting Section, Chamber of Commerce of the United States of America, provides its readership with the Chamber's official forecast of the U.S. economy. It analyzes the vital issues affecting current economic activity and provides the latest economic trends. Subscription cost is $60.00 per year.

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UNITED STATES ECONOMIC OUTLOOK 1991 - 1992

Prepared by the U.S. Chamber of Commerce

Third Quarter 1991

(Percent change from previous periods at seasonally adjusted annual rates unless otherwise indicated by shading.)

	QUARTERS						YEARS				
	Actual			Forecast			Actual			Forecast	
							Annual Average				
	91/1	91/2	91/3	91/4	92/1	92/2	'83-'88	1989	1990	1991	1992
GROSS NATIONAL PRODUCT											
Nominal GNP	2.2	4.2	4.5	3.5	3.8	5.1	7.5	6.7	5.1	3.3	4.4
Real GNP	-2.8	-0.1	1.6	-0.4	-0.6	1.8	4.0	2.5	1.0	-0.6	0.9
Consumption	-1.5	2.8	2.5	-1.0	-1.1	1.7	4.1	1.9	0.9	0.1	0.8
Residential Investment	-25.3	2.7	1.1	3.3	4.0	4.5	10.8	-4.1	-5.4	-13.4	3.8
Nonresidential Investment	-16.3	-1.8	-3.8	-2.0	-0.4	1.2	4.8	3.9	1.8	-4.5	-0.4
Equipment	-18.4	2.0	-2.6	-1.6	0.7	1.9	8.5	5.2	2.8	-3.0	0.5
Structures	-9.0	-13.7	-8.0	-3.5	-4.5	-1.3	-2.6	0.0	-1.2	-9.6	-3.8
Exports	0.5	4.3	2.1	4.5	2.2	3.5	6.7	11.0	6.4	4.0	3.6
Real Net Exports (82$B)	7.1	-14.5	-22.3	-23.4	-17.5	-15.3	-88.7	-54.1	-33.8	-13.3	-15.9
Imports	-8.8	19.0	6.7	5.0	-1.3	2.1	10.5	6.0	2.8	0.7	3.9
Government Purchases	-1.3	3.0	-3.1	-3.2	-0.9	-1.3	3.2	2.3	2.8	1.0	-1.2
Final Sales	-2.9	0.2	-0.2	-1.5	-0.2	1.4	3.8	2.5	1.6	-0.4	0.3
Change in Business Inventories (82$B)	-25.0	-27.7	-9.4	2.1	-1.8	3.6	21.6	23.8	-3.6	-15.0	6.9
Industrial Production	-9.7	2.2	3.7	0.4	-1.0	2.7	4.9	1.7	1.0	-2.3	1.5
New Car Sales (mill.)	8.2	8.5	8.7	8.8	8.9	9.2	10.5	9.9	9.5	8.5	9.4
Domestic Car Sales (mill.)	6.0	6.1	6.4	6.3	6.3	6.6	7.6	7.1	6.9	6.2	6.8
New Housing Starts (mill.)	0.92	1.00	1.07	1.10	1.15	1.20	1.68	1.39	1.20	1.03	1.21
EMPLOYMENT, WAGES AND PRICES											
Civilian Unemployment Rate (%)	6.5	6.8	6.9	7.3	7.5	7.6	7.2	5.3	5.5	6.9	7.5
Compensation	4.2	4.6	4.2	4.2	4.9	4.7	4.6	3.0	3.9	4.5	4.5
Productivity	0.0	0.5	0.9	0.4	0.7	0.9	1.9	0.2	-0.6	0.3	0.8
Unit Labor Costs	4.2	4.3	3.3	3.8	4.2	3.8	2.5	3.3	4.4	4.2	3.7
Consumer Price Index	3.5	2.3	3.6	4.6	4.5	3.7	3.5	4.6	5.4	4.4	4.1
Implicit GNP Deflator	5.2	4.2	3.1	3.9	4.6	2.8	3.3	4.1	4.1	4.0	3.6
Prime Interest Rate (%)	9.2	8.7	8.4	8.0	8.0	8.3	9.8	10.9	10.1	8.6	8.3
3-mos. Treasury Bill Rate (%)	6.0	5.6	5.4	5.3	5.4	5.8	7.8	8.1	7.5	5.6	6.0
Corporate Bond Rate (%)	8.9	8.9	8.8	8.8	8.9	9.0	10.7	9.3	9.3	8.8	8.9
Real Personal Disposable Income	-1.5	2.4	1.3	-0.6	1.5	2.5	3.6	2.4	0.9	-0.6	1.6
Changes in Profits from Current Production ($B)1	-2.7	1.7	1.3	4.3	4.1	1.6	29.8	-26.0	-13.4	-9.6	10.7

1Corporate profits with inventory valuation and capital consumption allowances.

FORECAST ASSUMPTIONS

This forecast table contains preliminary estimates of the National Income and Product Accounts for the second quarter of 1991. The nation's money supply M(2) is assumed to grow by 3.2 percent in 1991 and by 4.5 percent in 1992. The trade weighted exchange value of the dollar falls by 0.3 percent in 1991 and rises by 2.0 percent in 1992.

SOURCE: U.S. Chamber of Commerce, Forecast Section, using the Washington University macro model of the U.S. economy.

The economy has now suffered nine consecutive quarters of real GNP growth below 2 percent. For the past two years, real GNP has grown at a compound annual rate of 0.2 percent. And even though economic contraction probably ceased in May 1991, we foresee at least four more quarters of below 2 percent growth. The upswing in industrial production in autos especially, increased housing activity, and higher real consumption spending should produce a positive third quarter. Unfortunately, the economy will be vulnerable to a further decline in the fourth quarter of 1991 and the first quarter of 1992.

In fact, conditions may get worse. Beginning in July 1991, several states, California and Pennsylvania in particular, raised taxes to deal with their budget deficits. Federal spending appears to be running out of control and will rise above 25 percent of nominal GNP next year — a post World War II record. There is talk of raising federal taxes again. Business compliance costs for new regulations will increase by about $30 billion next year, almost equaling the burden of new federal taxes to be imposed in 1992 under current law. When the Clean Air Act fully takes effect, it will add another $40 billion to business compliance costs.

Our forecast for 1991 and 1992 has not changed for several months. Real GNP is expected to fall by 0.6 percent in 1991 and rise by just 0.9 percent in 1992. Third quarter real GNP, bolstered by auto production, will rise by 1.6 percent. However, poor auto sales will lead to production cutbacks in the fourth quarter, resulting in an annualized drop of 0.4 percent in real GNP. Increases in consumption in the third quarter cannot be sustained over the next year because income growth is very slow. Companies will not add to their employment roles in any significant way in the next six months, inhibiting income growth and resulting in an increase in the unemployment rate.

Our unemployment rate forecast has dropped somewhat, based on evidence that job seekers have become discouraged and are leaving the labor force. A smaller-than-previously-forecasted labor force will keep the unemployment rate from rising as high as we previously expected.

A small second dip into recession is a 60 percent probability. Thus, "double-dip" becomes our official forecast. But there are other scenarios that are certainly possible. There is a 30 percent chance that a recovery starting with the current quarter will occur, but with no more than 2 percent growth in real GNP over the next year. This possibility is driven by the potential for increased exports as economies around the world begin to grow faster than ours.

Another boon to the economy could come from lower-than-anticipated inflation and higher-than-anticipated productivity growth. Lower inflation would mean higher real disposable incomes for consumers, fueling an increase in consumer demand. Greater productivity growth would allow businesses to add to profits while cutting unit costs and expanding production. However, businesses are poised to increase production without expanding jobs or rehiring laid-off workers. If production is increased in this manner, income growth will be slight and the unemployment rate will not come down as the economy expands.

But the recovery, under any realistic scenario, cannot be as great as either Blue Chip forecasters or official Washington believes. Historically, the economy recovers at no more than twice the rate it enters a recession. In the four quarters preceding the 1990-91 recession, the economy grew by 1 percent. It will not grow by more than 2 percent over the next year even if the recovery is already underway. The Blue Chip consensus forecast for the next year — a 2.8 percent increase in real GNP — rates only a 10 percent probability. The Blue Chip scenario could occur only if, in addition to export, productivity, consumption and profit improvements, the economy experiences a broad upswing in investment. Unfortunately, the results of the U.S. Chamber's August 1991 poll of its members' outlook in the "Business Ballot" suggest that any meaningful increase in investment is unlikely. The poll shows reduced business confidence from the June 1991 poll — a clear indication that businesses will not add to capacity in the near future even if sales expand.

Aside from the fact that recoveries tend to be limited by the amount of growth preceding recession, the likely durability of anti-growth policies, especially the slow growth in M2 (money supply), serve as strict limits to GNP growth. Current M2 growth of about 3 percent is consistent with about 3 percent growth in nominal GNP over the next six months or so. Even if the Fed gets M2 growth up to the midpoint of its target range of 2.5 to 6.5 percent by the end of the year, nominal GNP growth is unlikely to exceed 4.5 percent in all of 1992.

Few analysts are emphasizing the relationship between M2 and nominal GNP as a constraint on how much inflation plus real GNP growth is possible. However, the relationship is certainly strong. In 23 of the last 30 years, rising M2 growth has led to rising nominal GNP growth in the following year. A more precise M2 and nominal GNP relationship has emerged in the past three years. Key to this relationship is the fact that when M2 growth lies above nominal GNP growth, within six to twelve months, nominal GNP growth will increase. If M2 growth lies persistently above or below nominal GNP growth, nominal GNP growth will continually rise or fall in response.

Since the beginning of 1988, M2 growth has been below nominal GNP growth. Nominal GNP growth peaked at 8.0 percent in mid-1988 and has fallen ever since closing what was once a large gap between M2 growth and nominal GNP growth. These two important economy-wide measures have finally come together settling in the range of 3.0 percent to 3.5 percent growth in the past year. One would think that inflation can finally come down since new demand is rising so slowly. However, real GNP growth or new supply is not rising at all. Consequently, almost all of new demand bids up prices and fuels inflation.

In short, nominal GNP growth will stay down around 3 percent unless M2 growth rises above it. While some analysts hope that an increase in the velocity of money (how fast the nation's money supply turns over into GNP) will break the hold on nominal GNP exerted by the money supply, empirical evidence shows that velocity tends to fall during recoveries. Velocity typically rises when inflation and inflation expectations shoot upward, both of which are unlikely to occur under the consensus forecast.

As events continue to unfold, we anticipate that both consensus analysts and official Washington will be forced to come to terms with slower nominal GNP growth. The consensus forecast for real GNP growth in 1992 will drop to just 2.0 percent by the beginning of the year, with government officials following somewhat behind. Government budget deficit forecasts will once again rise to new records as revenues are revised downward and expenditures upward. Indeed, we have already seen an incredible evaporation of 81 percent of the tax revenue increases from the celebrated "deficit reduction" law passed in late 1990. By January 1992, only 14 months after passing a supposed $500 billion deficit reduction package, some sober number-cruncher will have to conclude that deficit reduction never occurred. What is likely to occur instead is that five-year deficit estimates in January 1992 will exceed the five-year estimates that prompted the tax increase in the first place. So much for good government.

Unfortunately, without pro-growth policies, the outlook for the 1990s is for the worst decade of growth since the 1930s. Plotted against its 40-year historical baseline, real GNP growth has been falling from trend since mid-1988, creating a "growth gap." Since that time, nine consecutive quarters of below 2 percent economic growth have widened that gap substantially. It will continue to grow. Even under the optimistic Administration forecast, real GNP would be $275 billion below trend by the end of 1992 — a 6 percent growth gap.

At first glance, this growth gap may not appear too alarming in the aftermath of a recession. However, if the economy had suffered a 1981-82-like recession and experienced a 1983-84-like recovery between mid-1988 and the end of 1992, **the cumulative economic cost would actually have been less.** And since the more subdued, but still optimistic by our standards, consensus forecast for the rest of the 1990s produces a wider growth gap every year, we conclude that current federal policy has created a permanent growth gap and will produce a substantial loss in the U.S. standard of living.

Under a simulated early-80s recession and recovery, the cumulative growth gap — the difference between simulated GNP and the trend line — would be almost $700 billion from 1989 through 1992. The actual cumulative growth gap we will experience if the Bush Administration's economic forecast is correct will amount to $808 billion. Thus, the cost of virtual stagnation (economic slowdown, recession and anemic recovery) we are now experiencing will exceed the cost of a sharp, severe 1981-82-like recession and tax-cut-spurred recovery by 16 percent, leaving a family of four about $1,240 less in disposable income.

Even if the more optimistic Bush administration forecast through 1996 is correct, the cost of this period will be more than double that of the 1981-88 experience. The strong recovery in the mid-1980s kept the cumulative growth gap to $765 billion. But the Bush administration forecast, as optimistic as it is, creates a $1.8 trillion growth gap, a loss of about $2,500 per family per year. Of course, the Blue Chip consensus through 1996 and beyond is far less optimistic than the Bush administration forecast. If the consensus is correct, the cumulative growth gap will exceed $2 trillion.

Many analysts and policy makers mistakenly believe that the Fed can jumpstart the economy with a flood of new money. It has not, and it should not. What has to change dramatically, and soon, are fiscal and regulatory policies. Federal spending growth must be stopped and new regulations must be halted. Tax cuts, such as those already proposed in the Wallop-DeLay bill before Congress are the best bet for new economic growth.

To close the growth gap, the economy should at minimum be growing near 4 percent. If policies turned predominantly pro-growth, this would be possible. Without a renewed commitment to pro-growth policies, the economy will continue to lose ground. Someone may soon ask, "Were you better off in 1988 (or 1984) than you are today?" Or more simply, "Are things going in the right direction?" The answers are likely to be increasingly "no" over the next year.